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Fourth Quarter 2007

Panic, Redux

The market, after correcting severely in August and recovering during the 3rd quarter, declined again and returned to a state of panic as more bad news emerged from companies in the financial and housing markets. This led to another market correction, deeper and more severe than the one this summer, which has yet to show substantial recovery at the time of this newsletter in mid December.

In last quarter's newsletter, I wrote:

We are not nearly out of the woods yet. Most of the impairments in Q2 included just two weeks of problems starting in mid-June. Q3 will almost certainly contain more impairments, as things got really bad at the beginning of August and have not yet recovered.

The news that emerged in Q3 was indeed worse than what was reported in Q2. The numbers are astonishing, and orders of magnitude greater than what was reported in Q2. Citigroup for example announced estimated declines of $8-11 ***billion*** from their $55 billion of sub-prime exposure. Citigroup stock fell by about 35%, and they later raised $7.5 billion of new financing to shore up their balance sheet. HSBC took $3.4 ***billion*** in losses in its consumer finance segment. Numerous other lenders and consumer finance companies reported large impairments, fueling the panic in the markets.

Perhaps demonstrating how widespread the impacts are, the New York Times reported that the tiny Norwegian town of Narvik, situated above the arctic circle and with a population of less than 20,000, was suffering potentially catastrophic losses due to their investments in securities that are declining in value amidst the market turmoil. These securities, while seemingly not directly in sub-prime loans, are linked to the credit markets that are frozen deeper than a Norwegian winter.

The declines have not been limited to financial stocks. Technology bellwethers Cisco and Dell reported weak results in Q3 and their stocks each fell about 15%. Telecom companies such as Level 3 Communications are struggling to meet revenue targets, and those stocks are down as much as 50%. Many retailers such as Bed, Bath & Beyond and Office Max are down 30-50% during the year. Many other stocks in many industries fell sharply in Q3 and Q4 after posting disappointing results.

Throughout 2007, our portfolios have been concentrated in financial stocks, which in the short term has simply been the wrong place to be. Financial stocks have underperformed the market in every month so far in 2007, and had their worst year since 2002. The S&P financials have declined more than 20% in the past 6 months. This tremendous headwind has contributed to our poor performance over the last two quarters, as unprecedented market disruptions have had a major impact on financial companies of all kinds. It isn't just exposure to sub-prime mortgages – it is exposure to any part of the financial system. Four months after the "credit freeze" began, many mutli-billion dollar parts of the financial system are still not functioning at all.

Overall, I would characterize our investments this year as "good, but early". The stocks were cheap and seemingly safe at the time of purchase, but due to major disruptions and panic in the financial system, they got a lot cheaper. Clearly, looking back I could have been more cautious, and I

failed to recognize the magnitude of the crisis that was unfolding. Waiting a few months to make the same purchases would have provided dramatically better prices for the same businesses. However, the prices we paid were not high, even factoring in some impairments in the companies, so we should not be unreasonable in expecting some recovery once the market settles down.

This all has led our performance to be very disappointing in the short term. As of the third quarter of 2007, we are down for the year, both behind the S&P 500 and at a loss in absolute terms. The fourth quarter is not finished yet, but so far doesn't look to be reversing the trend. Our long-term results including those from prior years are still satisfactory. But, obviously, the short-term trend is in the wrong direction.

I am also conscious of the fact that not all Tidd Capital clients enjoyed the success of prior years, and are only experiencing the declines in recent quarters. It is my very strong preference that all clients experience similar long-term results, and results similar to mine, but that only comes with time.

We are now seeing many prominent value investors such as Warren Buffett, Lou Simpson, Marty Whitman, Wally Weitz, and Bill Miller buying stocks in the financial sector. Bill Miller made these comments in his Q3 report:

> *Where will the new leadership come from? The same place it usually does: the old laggards. I think the new leadership will be US, large-cap, dollar-based, and grow to encompass what no one wants to own today, especially financials and consumer.*
> ...
> *More particularly, just as the right thing to do in 2002 was to buy what everyone was panicked about, I think the greatest gains over the next 5 years will be made in those securities people are panicked about today.*

Meanwhile, Miller has been buying stocks in the financial sector, including Countrywide Financial, one of the most reviled stocks of 2007. Clearly many a smart investor believes that financial stocks will perform better in coming years than they have in 2007.

First Marblehead

First Marblehead has been under a cloud for over 2 years and one piece of bad news seemed to emerge after another. Most of the news, while not material, impacted the perception of the company. Unfortunately, recent events have finally caused an impairment to the company, and I regretfully exited the position at a loss while we see what transpires.

Marblehead is a capital markets company – they bring capital markets financing to clients for a fee. Unfortunately, in an unprecedented outage, the capital markets have been essentially closed for 4 months and counting. This results in Marblehead being temporarily unable to close any business. On top of this, there are concerns emerging about the default performance of their loans in the wake of the credit meltdown. Nothing conclusive has been found, but the worry alone is enough to have impacts. As Countrywide's Mozilo prophetically said earlier in the year, the crisis is more form than substance, but form will become substance if it goes on long enough.

I am still fundamentally positive on Marblehead. They have built a franchise for providing and selling private student loans, an area that all analysts agree has the best secular trends in consumer finance. At a time when educational costs are skyrocketing and the government is reducing

government-guaranteed programs, there is a tremendous demand for financing to help people improve their education. The loans are profitable, not dischargeable in bankruptcy and carry an interest rate that is reasonable for both the borrower and lender. Private student loans are a unique asset class, and provide investors with a way to invest for yield that is not exposed to mortgage or sub-prime problems. Despite the turmoil in the markets, Marblehead should eventually find a profitable way to sell their loans. The question is when, and on what terms. Without knowing the terms, it is very hard to have a sound investment case. This story is not over yet, and I'll continue to watch it closely.

Marblehead was unfortunately a large position for us, and represents the second time in 2007 that capital markets turmoil has stung us with a loss. The first rule of investing is never to lose money. The second rule, of course, is to see rule #1. Having violated rules #1 and #2 twice in the same year is a very disappointing outcome. This has renewed my focus on considering every conceivable downside scenario (and also entertaining some inconceivable ones) when entering a new investment, and also to give financial companies an even wider berth and more intense scrutiny than ever.

Perspective

In prior years with extremely positive quarters, I have warned clients and readers not to extrapolate the terrific results far into the future. Similarly, the recent poor results should not be considered a trend. Our results should be considered over the long haul.

The only way to be invested in the equity markets and retain one's sanity is to focus on a picture of at least 3-5 years. A 6-month period, no matter how dramatic, is still only a short-term event in the longer horizon. I thought two anecdotes might bring the point home.

Warren Buffett famously bought his stake in The Washington Post in 1973. He said that the company was obviously trading at 25% of fair value, something readily agreed upon by members of the financial press and analysts. He said he could have easily found more than 10 bids for the company at 4-5x is value at the time, but nobody wanted to own the stock.

He proceeded to buy 10% of the company. Throughout 1974 and 1975, the company continued to struggle, and revenues and earnings declined. The stock fell about 25%, so Buffett had a 25% loss after 2 years.

In 1977, four years after the purchase, the stock was worth three times what he paid, and today it is worth an astonishing ***117 times*** what he paid. When retelling this story 30 years later, those first two years obviously look immaterial. But at the time, after the first 2 years, the next 28 years were not known and many investors would have lost their nerve. By focusing on the long term, Buffett was able to make an excellent investment, even though he was not even within 2 years of the bottom.

Another example from Buffett's business partner Charlie Munger is interesting. Munger ran an investment partnership from 1962 to 1975. From 1962 to 1972, he handily outperformed the markets, establishing an excellent 10-year track record.

However, in 1974 and 1975, Munger's portfolio lost 32% ***each year***, resulting in a 53% decline in the entire portfolio over a two-year span. When recounting this period, Munger proudly states that he had communicated with his clients about market volatility and short-term results, and did not lose a single client despite these hair-raising losses. This is very fortunate, since the clients were then around

to enjoy the 73% increase in 1975, which recouped most of their losses and resulted in an excellent 13-year track record.

Looking Ahead to 2008

The financial and housing markets will probably continue to see trouble in 2008, and stocks in those sectors will probably continue to be volatile as a result. I believe there is a very real chance of a recession, as housing problems and cash-strapped consumers find it harder to spend than in the past. Many other parts of the economy are still doing fine, and many international economies are also doing quite well. The Canadian housing market for example is quite strong, and the Brazilian economy is continuing a multi-year boom. Various economies around the world driven by resources and oil are doing very well, including Canada, Brazil, and the UAE.

I believe that our companies will work through the problems in US markets, though results at some companies may not improve for some until late in the year. Our companies generally produce strong cash flow, have ample liquidity, cash ready to be deployed in buybacks and acquisitions, entrenched businesses, and management teams with a large stake in the same equity that we hold. Many of them are attractive acquisition targets as well, and shareholders may benefit from this environment through acquisitions. Many of our businesses have very little exposure to the US consumer and housing markets, and derive their business overseas in other markets that are doing well.

The market is also consumed with pessimism and worry, and as sentiments change, I expect some recoveries in stock prices. Aside from this, there are some specific catalysts that I expect in early 2008.

KHD Humboldt had a weak Q3, which led the stock to decline from all-time highs. Even so, demand is very strong for their products and services in several fast-growing economies around the globe. I expect them to post strong Q4 figures and announce a business backlog in excess of $1 billion, and project growth through the end of 2008. Additionally and perhaps more importantly, the company has announced that it will reveal "specific plans" for its cash surplus in Q1 2008, which I estimate will be approximately $300 million. Chairman Michael Smith has another $125 million of cash available at Mass Financial, an affiliated company. Having had a year to look for acquisition candidates and valuations now down to very attractive levels, and a large quantity of "dry powder", I expect KHD to announce some positive deals early in 2008.

ECC Capital continues its process of winding down, which has not been easy given the mortgage market conditions. However, the company has been effective in controlling expenses and hoarding cash, and in Q1 2008 should start to receive cash disbursements from their mortgage securities. This cash should lead to substantial cash distributions in early 2008. Our investment thesis here is strictly around receiving these cash distributions, though the stock will likely trade quite poorly in the meantime.

Brookfield Asset Management has taken advantage of the turbulent market conditions in Q4 to raise substantial capital and make several new deals. They exited profitable investments in Stelco and Bovespa, which together yielded $410 million of cash. They were able to execute a refinancing of One Liberty Plaza – the building adjacent to Ground Zero in Manhattan – to take about $240 million of cash out of the property. Their operations should produce in excess of $250 million of cash during the quarter, providing them with more than $900 million of fresh capital with which to make new investments. During the quarter they have already announced the acquisition of asset manager KG

Redding, increasing their assets under management by $6 billion. They also closed a large acquisition of shopping mall property in Brazil for $965 million, making Brookfield one of the largest owners of shopping malls in the fast-growing Brazilian economy. Brookfield is seemingly unimpaired in either capital raising or deal closing by the current market conditions, and is continuing to build on their foundation for long-term growth.

Our BDC companies are trading down to substantial discounts to net asset value (NAV), yet are showing very little in the way of actual impairments. The market is currently projecting beyond-worst-case scenarios for each company, resulting in prices well below fair value. Triangle Capital announced not only no impairments, but has grown NAV, earnings, and dividends substantially, yet is down nearly 20%. Gladstone Investment Corp announced an impairment of just 2.3%, yet the stock is down 25%. Meanwhile, this environment is actually much better for new investments made by these companies than prior years. As confidence returns to the financial sector, I expect these companies to trade up closer to NAV.

Administrative

I am also looking at making some changes to Tidd Capital business in 2008 to simplify operations and improve service and performance. In years past, I have had "aggressive" and "growth" strategies, the primary difference between the two was certain types of transactions such as arbitrage and work-outs, and modest use of margin borrowing. These transactions, at least the type that I look for, seem to have dried up completely, as I haven't seen one in about 5 or 6 quarters. The aggressive portfolios tend to be more volatile as well, as a result of having higher concentration of positions and modest leverage. In an effort to simplify our portfolios and moderate volatility, the "aggressive" strategy will be discontinued at the end of 2007. Client portfolios currently in this strategy will be adjusted to conform to the "growth" strategy. Currently, the adjustments are quite minor, and not many clients will be affected.

Another change is to be more assertive about enforcing the size limitation on individual accounts. In the past, we have freely accommodated accounts of nearly any size, including accounts for kids, small IRA's, etc. As the business has grown (now over 70 accounts), unfortunately the small accounts require a disproportionate amount of administrative and trading overhead, and tend to perform differently than the composite results. Clients will be better served by moving these accounts to other management firms with lower minimums. Over the next few weeks, I'll be contacting clients with these accounts to discuss the best way to smoothly transition them into new management.

Closing

2007 has been a very challenging year to be invested in the stock market, and one of the most difficult that I can remember. I appreciate the patience and trust shown by clients in difficult times, and will redouble efforts to put us on a better track in 2008 and beyond.

I hope that this letter has given you a better understanding of my investment process. If you have any questions or concerns, please feel free to contact me by phone or e-mail at any time.

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